APPENDIX

January 18, 1983

TO: Federal Open Market Committee

FROM: S. H. Axilrod

As mentioned by Chairman Volcker last Friday, a framework for specifying and explaining the operational meaning of longer-run monetary and credit targets for 1983 is attached for consideration. Such a framework provides a basis for construction of the directive to be adopted at the February meeting and for explanation in the semi-annual report to Congress. Specific numerical alternatives for the longer-term ranges for 1983 will be presented in the February blue book.

Attachment

January 18, 1983

The Federal Open Market Committee established growth ranges for M2 and M3 in 1983 of ___ to ___ and ___ to ___ percent, respectively. In association with these objectives, total credit was expected to expand in a ___ to ___ percent range. The Committee agreed that specification of a growth range for M1 was not feasible at this time because of distortions introduced by the transition to the money market deposit accounts (MMDAs) and super-NOW accounts that depository institutions have been able to offer at competitive market interest rates since mid-December and early January, respectively.

The super-NOWs are included in M1, but MMDAs, because of their more limited transactions features, are included only in the broader monetary aggregates. In the transition period, the nature and meaning of M1 may change substantially, as some investment-type funds shift into M1 through super-NOW accounts and some transactions funds shift out of M1 into MMDAs. Even after the bulk of shifts has been completed, the behavior of M1 will be difficult to evaluate before some experience is gained.

Nonetheless, the Committee intends to monitor developments with respect to M1 closely, in conjunction with the behavior of the broader monetary aggregates that will serve as the principal guides for monetary policy at least over the next several months. At the time of the mid-year report to Congress, the Committee will again assess the feasibility of providing a numerical specification for M1.

The behavior of the broader monetary aggregates will also be influenced in some degree by shifts of funds generated by the introduction of the new deposit accounts, with effects larger on M2 than on M3. Even

though the bulk of shifts is likely to be among components of these aggregates and thus will not affect the totals, shifts into MMDAs from market instruments, or from large time deposits currently included only in M3, will work to raise M2, especially early in the year when most of the adjustments are expected to take place. [Insert sentence about how ranges adopted for 1983, and possibly expected actual behavior relative to them, may be influenced by shifts.]

In assessing the performance of the aggregates over the year, and recognizing the inherent volatility of money and credit aggregates, the Committee will look not only to their growth from QIV '82 to QIV '83, but also will evaluate emerging trends on a year-over-year basis. Because growth of M2 and possibly also M3 may be higher relative to target early in the year, this would contribute to raising growth on a year-over-year basis. [The following language suggests an alternative method for basing the monetary aggregates in 1983: To reduce the distorting influence on growth ranges of the large-scale shifts of funds since the last half of December stemming from the public's initial adjustment to the newly available deposit accounts, the Committee's ranges for M2 and M3 represent annual rates of growth from the average levels of these aggregates outstanding in the three-month period from December '82 to February '83 (or two months from January '82 to February '83) to the average level in QIV '83.]

The associated range for total credit expansion provides a broader context for helping to interpret the behavior of the monetary aggregates over the course of the year as well as the thrust of monetary policy. This range represents the percentage increase in funds raised by domestic

nonfinancial sectors in the form of debt [and equity issues]. Such an aggregate is not likely to be much affected by shifting preferences by the public for various financial assets, including money and near-money assets, and by changes in the extent to which borrowers obtain the credit needed to finance economic recovery at depository institutions or in the open market.

Historical experience nonetheless suggests that the relationships to nominal GNP of credit aggregates, as well as of monetary aggregates, are relatively loose. On the credit side, spending can be financed out of internal cash flows or by drawing down existing assets, rather than by net additions to debt. On the side of money, existing cash balances can be employed more or less intensively in financing economic activity, as reflected in variations in the velocity of money. The broader aggregates, which are not closely related to the reserve base of depository institutions and which are largely composed of assets offering market interest rates, tend to fluctuate with credit demands, the aggressiveness with which institutions seek funds, and the public's savings propensities.

Thus, the implementation of monetary policy necessarily also involves evaluation of evolving market conditions, as typified by trends in domestic interest rates and the foreign exchange value of the dollar as well as by ongoing changes in the velocity of money or credit. They provide information about market expectations, demands for liquidity, attitudes toward inflation or disinflation, and the strength or weakness of credit demands that contributes to assessment of money and credit behavior in relation to the ranges set for them and the performance of the economy.